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SUBJECT: UKRAINE: NAFTOHAZ CONTINUES TO FACE MAJOR
FINANCIAL CHALLENGES

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[¶1.](#) (SBU) Summary. NaftoHaz, Ukraine's state-owned oil and gas enterprise, continues to face major financial challenges as Russia and Ukraine continue highly-anticipated 2009 gas negotiations. In addition to debt owed to its gas suppliers, NaftoHaz faces various other financial difficulties, including collecting payments from its customers and subsidiaries; Ukrainian government interference in price structuring; complications in plans to restructure the domestic gas market; and a likely steep gas price increase in [¶2009](#). The GOU proposed several actions intended to improve NaftoHaz's financial condition, but the 8 billion hryvnia (UAH) or \$1.58 billion NaftoHaz had hoped for in the state budget was not approved, forcing NaftoHaz to look outside the government for loans just to stay afloat. Despite NaftoHaz's troubles, the current government has also made all hydrocarbon development the direct responsibility of NaftoHaz, severely limiting opportunities for foreign investors to provide much-needed capital and technical know-how to the state-owned firm. End Summary.

What Does NaftoHaz Currently Owe for Gas?

[¶2.](#) (SBU) Pinning down the exact amount of debt NaftoHaz owes Gazprom and/or its intermediaries is extremely difficult. In July, RosUkrEnergo (RUE), the shadowy gas intermediary that purchases gas from Gazprom and sells it to NaftoHaz, accused NaftoHaz of owing it more than \$2 billion. According to RUE officials, this debt included arrears from previous years, the debt on Russian gas consumed in the first quarter of 2008, the debt for Central Asian gas shipped in the second quarter, and payments due for gas shipped in summer 2008. NaftoHaz asserted that its debt to RUE did not exceed \$897 million as of July 1, and that \$650 million of that amount was for gas purchased in June 2008, which was being paid on schedule. In August, NaftoHaz returned the equivalent amount of Central Asian gas to RUE as payment for the Russian gas previously consumed. The major outstanding issue appears to be whether, and how much, NaftoHaz owes RUE on gas from previous years. In addition to the RUE debt, the Ukrainian press reported the Ukrainian-based intermediary UkrHazEnerho (UHE) as claiming that NaftoHaz owes them \$270 million for gas purchases.

Where Does NaftoHaz Stand in Terms of Loans?

[¶3.](#) (SBU) While NaftoHaz tries to clear up its debts to Gazprom and the intermediaries, it remains saddled with a sizable loan burden. In a July press interview, NaftoHaz

Chairman Oleh Dubyna reported that payments of \$800 million had been made so far this year to service loans, decreasing NaftoHaz's current liabilities on foreign loans to 10.5 billion hryvnia (UAH) or \$2.3 billion. While NaftoHaz has not, according to Dubyna, increased its corporate debt in 2008, it is attempting to obtain UAH 8 billion in loans from Ukrainian banks for gas purchases as it tries to increase the amount of gas in storage to 15 billion cubic meters (bcm) from the current 8 bcm prior to the heating season. If it can store gas purchased at a cheaper price, it will delay exposure to the higher prices expected in 2009.

Outstanding Debt to NaftoHaz: Dividends, Transportation and Storage, and Nonpayment

14. (SBU) In addition to its outstanding liabilities, NaftoHaz continues to have difficulty in securing its accounts receivable, which include the following:

- Dividends: NaftoHaz claims that RUE obstructionism has prevented holding a UHE shareholder's meeting that could resolve the matter of more than \$180 million in UHE dividends owed to NaftoHaz for 2006-2007. (Note: NaftoHaz oil subsidiary Ukrnafta also owes NaftoHaz approximately UAH 2 billion (\$440 million) in dividends for oil revenue. End Note.)

- Transportation and Storage Fees: NaftoHaz claims that RUE owes it \$141.8 million for gas transit for the period of December 2007-July 2008, while UHE owes it about \$150 million for gas transportation and storage for the same period.

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- Customer Nonpayment: Nonpayment by customers continues to be a significant problem. According to Dubyna, gas consumers accumulated the following debts to NaftoHaz in January-May 2008: municipal heat producing plants--UAH 1.8 billion; residential consumers--UAH 153 million; industrial consumers--UAH 450 million.

GOU Pricing Policy Detrimental

15. (SBU) NaftoHaz is mandated by the government to supply gas at prices far below the cost of imported gas to residential consumers, state-financed entities and public utility companies. NaftoHaz officials complain that GOU pricing policies for gas make it difficult for NaftoHaz to improve its precarious financial situation. According to Dubyna, the GOU requires that NaftoHaz provide gas to households at around \$50 per thousand cubic meters (tcm). In theory, cheaper domestically-produced gas is supplied to these consumers but, in reality, the amount produced is insufficient to meet the demand and must be supplemented with imported gas. (Note: The current price for imported gas is currently \$179.5 per tcm. End note.) NaftoHaz officials assert that either gas prices should be raised or the GOU should subsidize the company for losses it incurs by selling gas to these sectors below cost. (Note: While there have been increases in rates to these groups, they have thus far been insufficient to make up for the shortfall. End Note.)

16. (SBU) In addition to setting prices based on consumer categories, the GOU sets the price for domestically produced gas at prices ranging from \$90-\$140 per tcm depending on the amount of consumption, which discourages exploration and production. NaftoHaz officials have stated that, for the first time, domestic gas production dropped in 2007 because it was no longer financially viable.

Intermediary UkrHazEnerho (UHE) Not Gone Yet

17. (SBU) Following Tymoshenko's gas negotiations with Russia

earlier this year, it appeared that UHEs days on the domestic market were numbered and that NaftoHaz would once again be able to profit from sales to industrial customers. Ukraine succeeded in having NaftoHaz replace UHE as the importer of natural gas to Ukraine, an important step towards reclaiming its former prominence in the domestic market. However, court decisions have breathed new life into the gas intermediary. The Kyiv administrative court of appeals this past summer ruled against a decision by the National Electricity Regulatory Commission that had limited the volume of gas UHE could supply to Ukrainian consumers at an unregulated rate. Limitations were subsequently lifted and it is uncertain whether UHE will undersell NaftoHaz to lure away industrial customers. NaftoHaz, as the sole importer of gas to Ukraine, presumably will not sell to UHE; it already is selling 7.5 bcm to Gazpromsbyt of Ukraine, a Gazprom subsidiary and the named replacement for UHE. If that is the case, UHE would be limited to selling only the gas it presently has in storage, but could still eat into NaftoHaz's anticipated income this year.

Gas Price Negotiations for 2009 Don't Bode Well

18. (SBU) When Tymoshenko returned from talks in Moscow in late June, she announced that she had reached an understanding with Putin to raise the price of gas sold to Ukraine to European levels over a three or four year period and expected to sign a long-term gas agreement reflecting this by September 15. Putin reportedly indicated he supported the gradual price increase in principle, but stated that the prices would be worked out by the companies involved and would be affected by the Central Asian gas price for 2009. Based on a July 25 preliminary agreement between Gazprom and Turkmenistan on price formation principles, Russian energy analysts calculate that Gazprom would purchase Turkmen gas in 2009 at a price ranging from \$225 to \$295 per tcm. Such a scenario would imply that the price of gas for Ukraine will rise sharply from the current \$179.5 per tcm, edging uncomfortably close to \$400 for Ukraine as originally put forward by Gazprom as a possibility. Nevertheless, the significant price jump would continue to push NaftoHaz into

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further arrears, especially if NaftoHaz is prevented from passing on increased costs to its customers.

Recent and Ongoing Audits

19. (SBU) According to NaftoHaz's 2006 Consolidated Financial Statements, audited by Ernst and Young, NaftoHaz incurred a net loss attributable to equity holders of UAH 2,205 million and as of December 31, 2006, its current liabilities exceeded its current assets by UAH 12,219 million. The press has reported that Ernst and Young continues to complete its 2007 audit, and those results are not expected until the summer of 2009. On a separate track, Chief of the Main Auditing Directorate, Mykola Syvulskyy, has sent a preliminary audit report on NaftoHaz to the Cabinet of Ministers. In a press interview, Syvulskyy indicated that former senior managers of NaftoHaz deliberately tried to bankrupt the company.

GOU Assistance for NaftoHaz

10. (SBU) The 2008 national budget contains a provision compensating NaftoHaz for the losses incurred on selling gas to public utility companies in the amount of UAH 4.3 billion. The Cabinet of Ministers (CabMin) has also proposed that parliament grant a non-interest-bearing loan of UAH 800 million to NaftoHaz to buy and pump imported natural gas to underground gas storage facilities in 2008, which would be transferred to heat supply companies next year. In addition, the Cabinet tabled a draft law in the Parliament obliging NaftoHaz-founded companies UHE and Ukrnafta to pay NaftoHaz

approximately UAH 2.5 billion in dividends from revenue received in 2006-2007.

Weak FY07 Results Anticipated

¶11. (U) On August 8, Moody's Investors Service downgraded NaftoHaz's Ba3 foreign currency corporate family rating to B1. Less than a week later, Fitch Ratings issued a press statement indicating that it anticipates weak FY07 results, stemming largely from NaftoHaz's inability to fully recover gas import prices from its domestic sales. In Fitch's view, a positive resolution of the state budget and gas storage financing issues might be sufficient to avoid a negative credit impact from the publication of weak FY07 results. In addition, there are growing concerns that NaftoHaz could find itself in technical default because it is late in reporting its financial results.

¶12. (SBU) COMMENT: NaftoHaz continues to face severe financial challenges. Even if its debt to RUE is relatively minimal, servicing and paying off loans will continue to make capital scarce for the company and, with significantly higher gas prices seemingly inevitable in 2009, it will become increasingly difficult for NaftoHaz to achieve profitability.

Moreover, NaftoHaz's financial straits leave NaftoHaz little money for the development of much-needed hydrocarbons, which the Tymoshenko government believes should be developed solely by NaftoHaz without the capital or technical assistance of foreign partners. End comment.

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